

## Internal Revenue Service

Department of the Treasury  
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TY:

### LEGEND:

Taxpayer =  
Facility =  
State =  
Location X =  
Location Y =  
Location Z =  
Authority =  
Target =  
Target Sub =

Date 1 =  
Date 2 =  
Date 3 =  
\$a =  
\$b =  
Business A =  
Business B =

Dear

This responds to your request for a private letter ruling, dated May 14, 2008, regarding the application of § 1033 of the Internal Revenue Code to your proposed transaction. The questions you raise concern whether the acquisition of the stock of a corporation will qualify as replacement property under § 1033(a)(2)(A).

### FACTS:

Taxpayer is a U.S. corporation engaged in Business A. Taxpayer owns the Location X Facility, which is presently under threat of condemnation by Authority. The Location X

Facility consists of 20 acres of land improved with an office structure (including several storage sheds, a maintenance shop and a lunchroom building), and related personal property.

For purposes of § 1033(a)(2)(B) (relating to the period in which converted property must be replaced – the § 1033 replacement period), the involuntary conversion at issue commenced on Date 1, when Authority threatened condemnation of Taxpayer's Location X Facility for stated public purposes. On that date Authority passed a resolution in a public meeting authorizing it to commence negotiations and appropriations to acquire several properties, including Taxpayer's Location X Facility, and to begin condemnation procedures if direct purchase efforts were unsuccessful. Authority has eminent domain powers derived from the constitution of the State. Subsequently, on Date 2, Authority filed suit in the appropriate state court to exercise this power. After the sale of the Location X Facility to Authority, the Location X Facility may be leased back to Taxpayer for a limited time.

Taxpayer plans to defer gain from the conversion of its property under § 1033 by purchasing the common stock of Target as replacement property for the condemned Location X Facility. After learning of the threatened condemnation on Date 1, Taxpayer, on Date 3, purchased about 77 percent of the stock of Target for approximately \$a. Target is a domestic corporation headquartered in Location Y. Target owns and operates Business B and owns 100 percent of the stock of Target Sub. Target Sub, a domestic corporation that engages in Business A, owns the Location Z Facility. Before Taxpayer acquires an 80 percent interest in Target, Target will acquire direct ownership of Target Sub's Location Z Facility by liquidation under § 332.

After the liquidation of Target Sub and during the remainder of the replacement period, Taxpayer will purchase additional common and/or preferred stock of Target such that it will own more than 80 percent of the total combined voting power of all classes of Target stock entitled to vote and 80 percent of the total number of shares of all other classes of Target stock. Such additional common or preferred stock will be issued directly by Target. Future purchases could also include purchases of stock from unrelated shareholders.

Target Sub's Facility is located at Location Z. Similar to the Location X Facility, Target Sub's Location Z Facility consists of land (between 30 and 40 acres) improved with an office structure (including several storage sheds, a maintenance shop and lunchroom building). It also includes items of personal property that are similar or related in service or use to the personal property located and used at the Location X Facility.

The value of Target's Business B is estimated to not exceed \$b and the Location Z Facility (including the personal property located and used at the Facility) will be more than 90 percent of Target's total assets. Target intends to sell Business B in the near future.

Taxpayer makes the following additional representations with regard to its ruling application:

- The Location Z Facility is similar or related in service or use to the Location X Facility.
- The purchases of Target's stock will be either at prices intended to represent fair market value or at pre-negotiated prices from unrelated shareholders.
- Taxpayer intends for Target's stock to be used as replacement property for the condemned Location X Facility.
- Prior to Taxpayer's purchase of stock in Target, neither Target nor Target Sub was related to Taxpayer.

APPLICABLE LAW and ANALYSIS:

Issue No. 1: Whether the purchase of an 80 percent or greater controlling interest in Target can be achieved in multiple purchases.

Section 1033 (a)(2)(A) generally provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money and the taxpayer, within the period provided in §1033(a)(2)(B) and for the purpose of replacing such property, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. For purposes of § 1033(a)(2)(A), --

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of § 1033(b), the unadjusted basis of such property or stock would be its cost within the meaning of § 1012.

Section 1033(a)(2)(E)(i) provides that for purposes of §1033(a)(2), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Under § 1033(a)(2)(B), the § 1033 replacement period begins on the earlier of the date the converted property is sold or the date the taxpayer became aware of the threat or imminence of condemnation and, except as provided in § 1033(g), ends 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

In the present case, Taxpayer's § 1033 replacement period began when Authority threatened condemnation of Taxpayer's Location X Facility on Date 1. The replacement period will end two years after the close of the taxable year in which Taxpayer sells the Location X Facility to Authority, thus realizing a gain. The first purchase of Target stock, which was a 77 percent interest, occurred on Date 3, (after the threat of condemnation but before the sale of the Location X Facility). In addition, Taxpayer's intended purchase of all additional stock of Target necessary for control of Target, as defined in § 1033(a)(2)(E)(i), will also occur during the replacement period.

The requirements under § 1033 concerning the replacement of converted property are that the property must be acquired within the replacement period, the taxpayer must acquire the replacement property with intent to replace the converted property and the acquisition must be by purchase so that, but for the provisions of § 1033(b), the unadjusted basis of such property would be its cost. No language in either § 1033 or the regulations thereunder limits the number of purchases a taxpayer may make within the replacement period to make a valid replacement of converted property. Also, the focus of the provisions of § 1033(a)(2)(A) dealing with replacement by stock acquisition is on the acquisition of control of a corporation owning the property, similar or related in service or use to the converted property, within the time limits prescribed in § 1033(a)(2)(B). The number of purchases is not mentioned. Therefore, provided all other requirements for deferral under § 1033 are satisfied, Taxpayer may acquire the controlling interest in Target through multiple purchases.

Issue No. 2: Whether Target stock, to be acquired during the replacement period, qualifies as replacement property for Taxpayer's Location X Facility for purposes of § 1033(a)(2).

In Rev. Rul. 66-33, 1966-1 C.B. 183, the taxpayer elected to treat the sale of a radio station as an involuntary conversion under § 1033 and former § 1071 (pertaining to exchanges to effectuate policies of the Federal Communications Commission, until its repeal as of January 17, 1995). As replacement property, the taxpayer acquired stock of a corporation that did not own property that was similar or related in service or use to the converted property, but instead owned 100 percent of the stock in an entity that owned such property. Rev. Rul. 66-33 holds that the purchase by the taxpayer of stock of a corporation that does not own similar or related in service or use property, but owns all the stock of a subsidiary corporation which owns and operates such property, is not a valid replacement for purposes of § 1071. Consequently, the transaction failed to qualify for deferral of gain under §§ 1033 and 1071.

In the present case, Taxpayer is not acquiring control of a corporation that only indirectly holds similar or related in service or use property through a subsidiary. Rather, by the time Taxpayer gains control of Target, Target Sub, which owns the Location Z Facility prior to its acquisition by Target, will no longer exist for federal income tax purposes and Target will directly hold property that is similar or related in service or use to the converted property. While Taxpayer will purchase 77 percent of the stock of Target before Target owns similar or related in service or use property, all of the purchases will occur in the replacement period with intent to replace the converted property. Also, by the time Taxpayer gains control of Target it will directly own property that is similar or related in service or use to the converted property. Accordingly, all purchases of Target stock by Taxpayer in the replacement period qualify as replacement property within the meaning of § 1033(a)(2)(A).<sup>1</sup>

Issue No. 3: Whether the amount of the basis reductions for Target's stock and Target's underlying assets required by § 1033(b) will be determined at the time the Location X Facility is sold.

Section 1033(b)(2) provides that in the case of property purchased by the taxpayer in a transaction described in § 1033(a)(2) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than 1 piece of property, the basis shall be allocated to the purchased properties in proportion to their respective costs.

Section 1033(b)(3)(A) provides that in the case of property held by a corporation the stock of which is replacement property, if the basis of stock in a corporation is decreased under § 1033(b)(2), an amount equal to such decrease shall also be applied to reduce the basis of property held by the corporation at the time the taxpayer acquired control (as defined in § 1033(a)(2)(E)) of such corporation.

Section 1033(b)(3)(B) provides that § 1033(b)(3)(A) does not apply to the extent that it would (but for § 1033(a)(3)(B)) require a reduction in the aggregate adjusted bases of the property of the corporation below the taxpayer's adjusted basis of the stock in the corporation (determined immediately after such basis is decreased under § 1033(b)(2)).

Section 1033(b)(3)(C) provides that the decrease required under § 1033(b)(3)(A) shall be allocated-- (i) first to property which is similar or related in service or use to the converted property, (ii) second to depreciable property (as defined in § 1017(b)(3)(B)) not described in clause (i), and (iii) then to other property.

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<sup>1</sup> As noted above, Taxpayer acquires some of the stock of Target after the threat of condemnation, but before the sale, of the Location X Facility. Under § 1033(a)(2)(A)(i), Taxpayer's purchases of Target stock before the sale of the Location X Facility qualify as replacement property within the meaning of § 1033(a)(2)(A) only if Taxpayer still owns such stock on the date it sells the Location X Facility.

The express language of § 1033(a)(2)(A)(i), as cited above, allows anticipatory replacement of converted property prior to the disposition of the converted property. However, in the present case, since the sale of the Location X Facility is the event that determines the deferred gain associated with the disposition of the converted property (and the corresponding basis reductions), such deferred gain amount will not be known until the sale of the Location X Facility to Authority. In addition, although § 1033(b)(3)(A) provides for the reduction in basis of property held by the corporation at the time the taxpayer acquires control, § 1033(b)(3)(A) refers to the property to which the basis reduction applies, not to the date on which the basis reduction computations are to be made. Accordingly, the basis reductions under § 1033(b) should be made as of the date on which the Location X Facility is sold to Authority.

Issue No. 4: Whether basis adjustments required pursuant to § 1033(b)(3), if any, will be based on the adjusted basis of Target's assets, unreduced by Target's liabilities.

When converted property is replaced by the acquisition of stock, the taxpayer must reduce the adjusted basis of the acquired stock in accordance with § 1033(b)(2). In addition, § 1033(b)(3) requires the taxpayer to make a corresponding reduction to the adjusted basis of the property of the acquired corporation, but not below the taxpayer's adjusted basis in the acquired stock. Section 1033(b)(3) makes no mention of liabilities being taken into account in the § 1033(b)(3) basis determination. Therefore, following the acquisition of Target's stock, Taxpayer must reduce the adjusted basis of Target's property in accordance with § 1033(b)(3). In addition, the basis of Target's property is not to be reduced below Taxpayer's basis in the Target stock, as determined under § 1033(b)(2), unreduced by Target's liabilities.

Issue No. 5: Whether all of Target's stock acquired by Taxpayer will constitute similar or related in service or use property within the meaning of § 1033(a)(2), if Target's property consists principally, but not entirely, of property that is similar or related in service or use to the converted property.

As previously stated, § 1033(a)(2)(A) allows a taxpayer to replace converted property by purchasing stock in the acquisition of control of a corporation owning property that is similar or related in service or use to the converted property. Section 1033, however, does not address the amount of similar or related in service or use property a corporation must own for a stock purchase to qualify as replacement property.

In *Templeton v. Commissioner*, 67 T.C. 518 (1976), *supplementing* 66 T.C. 509 (1976), *aff'd per curiam*, 573 F.2d 866 (4<sup>th</sup> Cir. 1978), an individual whose land had been condemned acquired stock in a corporation as replacement property. Although the corporation owned some property similar or related in service or use to the condemned property, such property was not the principal asset of the corporation when the taxpayer acquired a controlling interest. Consequently, the court determined that the taxpayer was ineligible for deferral of the gain realized on the conversion. In concluding that

§ 1033 did not apply, the court stated that a taxpayer's acquisition of stock qualifies under § 1033 only if the taxpayer acquires control of a corporation whose assets consists principally of similar or related in service or use property not owned by him immediately before the acquisition.

In addition, Rev. Rul. 69-242, 1969-1 C.B. 200, concluded that a taxpayer's acquisition of a controlling interest in a corporation, the assets of which consisted principally, but not entirely, of property similar or related in service or use to the converted property, qualifies as adequate replacement under § 1033. In Rev. Rul. 69-242, an individual realized \$100x of gain for the condemnation of his investment real estate. (The adjusted basis of the converted property was \$125x and the individual received \$225x as proceeds for the condemnation). The desired replacement property was an asset of a corporation; but the corporation would not sell the asset directly to the taxpayer. Consequently, the taxpayer paid \$200x for all of the stock in the corporation, which owned both similar in service or use property and other property. The \$200x purchase price was determined as follows: the value of the corporation's similar or related in service or use property was \$300x and was encumbered by a \$150x mortgage, and the value of its other property was \$50x. Pursuant to a prearranged plan, the taxpayer liquidated the corporation within 30 days after buying the stock.

The taxpayer in Rev. Rul. 69-242 was required to recognize \$25x of gain because it only reinvested \$200x of the \$225x conversion proceeds. However, the revenue ruling did not require recognition of gain simply because the acquired corporation owned property that was not similar or related in service or use property. Consequently, Rev. Rul. 69-242 supports the position that a taxpayer's acquisition of a controlling interest in a corporation, the assets of which consist principally, but not entirely, of property similar or related in service or use to the converted property, qualifies as a replacement of converted property under § 1033(a)(2)(A). In addition, if a purchase of a controlling interest in a corporation qualifies as a replacement of converted property under § 1033(a)(2)(A), the entire purchase price of that controlling interest is taken into account in determining the amount of gain deferred under § 1033, even if the acquired corporation owns some property that is not similar or related in service or use to the converted property.

In the present case, the assets of Target will consist principally of property that is similar or related in service or use to the Location X Facility at the time that Taxpayer acquires control of Target. The dissimilar property of Target constitutes less than 10 percent of Target's total assets. Accordingly, except to the extent Taxpayer sells stock of Target before the sale of the Location X Facility, the total purchase price paid by Taxpayer for Target's stock constitutes a reinvestment in property similar or related in service or use to the converted property within the meaning of § 1033(a)(2)(A).

**RULINGS:**

1. Taxpayer may acquire a controlling interest in Target through multiple purchases.
2. Taxpayer's purchase of Target's stock qualifies as replacement property when, prior to Taxpayer's acquisition of a controlling interest in Target, Target Sub liquidates under § 332 into Target so that Target will directly own the property that is similar or related in service or use to the Location X Facility.
3. The basis adjustments required under § 1033(b) will be applied using Taxpayer's adjusted basis in Target's stock and Target's basis in its assets, and these adjustments should be made at the time of the disposition of the Location X Facility.
4. Taxpayer's adjusted basis in the Target stock and Target's adjusted basis in its assets will not be reduced by any liabilities of Target.
5. Except to the extent Taxpayer sells stock of Target before the sale of the Location X Facility, all of Target's stock will constitute "similar or related in service or use" property within the meaning of § 1033(a)(2)(A), because Target's assets consist "principally" of property similar or related in service or use to the converted property at the time Taxpayer acquires control of Target.

**CAVEATS:**

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed



by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro  
Branch Chief, Branch 4  
(Income Tax & Accounting)